

**DEPARTMENT OF STATE REVENUE**  
**LETTER OF FINDINGS: 02-0057**  
**Indiana Gross Retail Tax**  
**For the Tax Years 1997, 1998, and 1999**

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**ISSUES**

**I. Taxpayer's Ammonia Cooling System – Gross Retail Tax.**

**Authority:** IC 6-2.5-1-1 et seq.; IC 6-2.5-5-3(b); Indianapolis Fruit Co. v. Dept. of State Revenue, 691 N.E.2d 1379 (Ind. Tax Ct. 1998); Mid-America Energy Resources v. Dept. of State Revenue, 681 N.E.2d 259 (Ind. Tax Ct. 1997); 45 IAC 2.2-5-8(c); 45 IAC 2.2-5-8(d); 45 IAC 2.2-5-8(e).

Taxpayer argues that the audit erred when it determined that taxpayer's purchase of an ammonia cooling system was subject to the state's gross retail (sales and use) tax. Taxpayer maintains that the cooling system is used within its manufacturing process and, because the cooling system has an immediate effect on its product, it is entitled to the manufacturing exemption.

**II. Abatement of the Ten-Percent Negligence Penalty.**

**Authority:** IC 6-8.1-10-2.1; IC 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer urges the Department of Revenue (Department) to exercise its discretion to abate the ten-percent negligence penalty imposed at the time of the original audit. Taxpayer believes it is entitled to abatement of the penalty because any errors it made in calculating its sales and use tax liability were not due to its own negligence.

**STATEMENT OF FACTS**

Taxpayer produces refrigerated, ready-to-bake, dough products at an Indiana manufacturing facility. A tax audit was conducted resulting in additional assessments of use tax. Taxpayer disagreed with a number of those additional assessments and submitted a protest. An administrative hearing was conducted, and this Letter of Findings follows.

**DISCUSSION**

**I. Taxpayer's Ammonia Cooling Systems – Gross Retail Tax.**

After taxpayer's products have been individually packaged and palletized, the products are transferred to a refrigerated "finished goods storage area" (taxpayer's terminology). In that storage area, the products are cooled to a pre-determined temperature – between 33 and 40 degrees F. – before being transferred to an off-site shipping warehouse. Taxpayer was assessed use tax on the purchase price of an ammonia refrigeration system used to cool the finished goods storage area; the audit concluded that the ammonia refrigeration system was not part of taxpayer's production activities and imposed an additional use tax assessment. Taxpayer disagrees arguing that its manufacturing process is not complete until after the products leave the finished goods storage area.

In Indiana, a sales tax is imposed on retail transactions and a complementary use tax is imposed on tangible personal property that is stored, used, or consumed in the state. IC 6-2.5-1-1 et seq. In this instance, taxpayer relies on the tax exemption found at IC 6-2.5-5-3(b). That particular exemption states that: "Transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property." It is taxpayer's contention that the ammonia refrigeration equipment falls within the definition of "direct use" as provided in 45 IAC 2.2-5-8(c). That regulation reads as follows:

The state gross retail tax does not apply to purchases of manufacturing machinery, tools, and equipment to be directly used by the purchaser in the production process provided that such machinery, tools, and equipment are directly used in the production process; i.e., they have an immediate effect on the article being produced. Property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which produces tangible personal property.

Taxpayer's refrigerated dough products are mixed to specific temperature. It is taxpayer's contention that its products are not complete until the products reach a certain temperature in its refrigerated finished goods storage area. According to taxpayer, the temperature in the refrigerated storage area is critical in controlling the amount of carbon dioxide gas within the product. If the temperature is too high, too much carbon dioxide gas will be produced resulting in low density, low weight product. If the temperature is too low, too little carbon dioxide will produce a high density, high weight product. In addition, maintenance of the proper temperature is needed to achieve and maintain an optimum pressure within the individual dough containers.

There is no question that taxpayer is involved in the production of tangible personal property and is entitled to claim the exemption for equipment directly involved in the direct production of that personal property. The issue is whether the ammonia refrigeration system, used to cool taxpayer's finished goods area, is employed *within* taxpayer's production process.

As used within the exemption statute, "production" is broadly defined and "focuses on the creation of a marketable good." Mid-America Energy Resources v. Dept. of State Revenue, 681 N.E.2d 259, 264 (Ind. Tax Ct. 1997). In Indianapolis Fruit Co. v. Dept. of State Revenue, 691 N.E.2d 1379 (Ind. Tax Ct. 1998), the court held that appellant taxpayer's equipment involved in the production of ripened bananas was entitled to the sales and use tax exemption. Id. at 1386.

The court found that appellant taxpayer's introduction of ethylene gas into the banana ripening process was "sufficient to constitute production." Id. at 1385. In contrast, the court held that appellant taxpayer's tomato ripening equipment was not entitled to the exemption because that particular ripening activity "was essentially passive in nature." Id. at 1386. The court summarized the distinction as follows: "With respect to the bananas, [taxpayer] actively induced the ripening; it did no such thing with respect to the tomatoes. In other words, the difference is that, with respect to the bananas, [taxpayer] made something happening; with respect to the tomatoes, [taxpayer] let something happen."

Taxpayer's production of refrigerated dough products is not complete until the most marketable product is achieved. That marketable product is not obtained until the individual product items have reached a desired consistency, density, and pressure. Those particular qualities are not realized until the products have been cooled to a particular temperature and then maintained at the temperature for a specified amount of time.

None of this occurs spontaneously because taxpayer's cooling activities are analogous to the banana ripening activities in Indianapolis Fruit. In that particular case, the appellant taxpayer would not have obtained saleable bananas without the introduction of ethylene gas because the bananas would not have satisfactorily ripened on their own. Similarly, taxpayer would not have obtained a marketable refrigerated dough product without acting to cool that product for a pre-determined time and to a pre-determined temperature. Taxpayer's dough product, as it comes immediately off the production line, is unmarketable and unusable. Although unrefrigerated dough would have produced carbon dioxide even without the cooling equipment, unless taxpayer had acted upon the dough in such a way as to directly control the carbon dioxide level, taxpayer's room temperature dough products would be as unmarketable as unripened or spoiled bananas. As set out in 45 IAC 2.2-5-8(d), "'Direct use in the production process' begins at the point of the first operation or activity constituting part of the integrated production process and ends at the point that the production has altered the item to its completed form . . . ." Taxpayer's dough products have not achieved their "completed form" at the time the products first leave taxpayer's production line. However, after 48 hours in the "finished goods storage area," the dough products are ready to be marketed to the ultimate consumer. As in Indianapolis Fruit, during the 48 hours the products are maintained in the finished goods storage area, taxpayer is "[making] something happen."

However, taxpayer errs when it claims that its production "is not complete until after the products leave the finished goods storage area." Taxpayer's exemption claim is limited to the extent that the ammonia refrigeration system was acquired for "direct use in the direct production, manufacture . . . of other tangible personal property." IC 6-2.5-5-3(b). After 48 hours of cooling, the product has achieved the proper amount of carbon dioxide, the individual product containers have achieved the desired amount of pressure, and the previously unfinished products can be purchased and used by the consumer. It is at this point that "direct production" ceases and the finished product is simply being preserved in a saleable condition. There is nothing within IC 6-2.5-5-3(b) or 45 IAC 2.2-5-8(c) which permits a manufacturer to claim the exemption for equipment being used to preserve an otherwise finished product. To the contrary, 45 IAC 2.2-5-8(e), Example One, specifically provides that "Purchases of refrigeration equipment used in milk production during the production process are exempt. However, refrigeration equipment used to

store milk products *subsequent* to production is taxable.” (*Emphasis added*). Accordingly, to the extent that the ammonia refrigeration equipment is directly used for 48 hours in the direct production of its refrigerated dough products, taxpayer is entitled to the exemption available under IC 6-2.5-5-3(b) and 45 IAC 2.2-5-8(c). However, to the extent the ammonia refrigeration equipment is used to maintain the finished product in a saleable condition before transfer to taxpayer’s shipping warehouse, the exemption is unavailable.

**FINDING**

Taxpayer’s protest is sustained.

**II. Abatement of the Ten-Percent Negligence Penalty.**

Taxpayer protests the assessment of the ten-percent negligence penalty on the amount of use tax deficiency determined at the time of the original audit.

IC 6-8.1-10-2.1 requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer’s negligence. Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to “be determined on a case-by-case basis according to the facts and circumstances of each taxpayer.” *Id.*

IC 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on “reasonable cause and not due to willful neglect.” Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish “reasonable cause,” the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . .”

Taxpayer has offered evidence sufficient to establish to establish that it exercised “ordinary business care” and that its failure to pay the use tax deficiency was due to reasonable cause and not due to willful neglect. The audit report indicated that taxpayer maintained a “very extensive and highly utilized use tax accrual system in place” and that taxpayer’s sales tax records and procedures “were found to be substantially correct.”

**FINDING**

Taxpayer’s protest is sustained.